

STATE AUDITOR'S OFFICE
SECURITIES DEPARTMENT
HELENA, MONTANA

IN THE MATTER OF:)	CASE NO. I-04-02-98-04
)	
International Heritage, Inc.,)	<u>CEASE AND DESIST ORDER</u>
Stanley H. Van Etten,)	
Claude W. Savage,)	
Larry G. Smith,)	
and)	
International Heritage,)	
Incorporated, a Nevada corporation,)	
)	
and their agents &)	
representatives,)	
)	
Respondents.)	

The Montana Securities Commissioner (commissioner), pursuant to the authority of the Securities Act of Montana, § 30-10-101, et seq., hereby issues the following findings of fact, conclusions of law, order and notice of right to a public hearing:

FINDINGS OF FACT

1. International Heritage, Inc., (IHI) is a North Carolina corporation whose principal offices are located in Raleigh, North Carolina. International Heritage, Inc., is a majority owned subsidiary of International Heritage Incorporated, a Nevada Corporation (IHI-N) (formerly "Kara International, Inc.").

2. Stanley H. Van Etten (Van Etten), is a founder, chairman of the board of directors, president, and chief executive officer of IHI, and is chairman of the board and chief executive officer of

1 IHI-N.

2 3. Claude W. Savage (Savage) is a founder and a director of
3 IHI and is director of IHI-N.

4 4. Larry G. Smith (Smith) is a founder and director of IHI
5 and a director of IHI-N.

6 5. Johnny Daniels (Daniels) is an independent sales
7 representative of IHI who resides in Malta, Montana. Daniels
8 conducts IHI training sessions and has marketed IHI business center
9 interests in Montana.

10 6. IHI, its principals, employees, and agents solicited
11 investments in IHI's program in Montana through the use of
12 promotional materials, videotapes, recruitment meetings, and
13 internet web sites. IHI, through Van Etten, Savage, Smith,
14 Daniels, and others solicited residents of Kalispell, Anaconda,
15 Butte, Billings, Bozeman, Lewistown, Great Falls, Glasgow, Malta,
16 Glendive, Roundup, Forsyth, Havre, Columbia Falls, Stevensville,
17 Helena, and other Montana towns to invest in a pyramid scheme.

18 7. IHI interests are described as "business centers," of
19 which an investor may open one, three, or seven. In order to open
20 or create a "certified" business center, Montana investors were
21 generally required to pay the sum of \$200.00 to \$250.00 toward the
22 purchase of an IHI product, sign a "retail business agreement,"
23 purchase an IHI retail business career kit for \$100, and pay a
24 \$25.00 administrative fee.

1 8. At all times material hereto, IHI solicited Montana
2 investors through the purported use of a "multi-level" marketing
3 program in which prospective investors are recruited by investors
4 who have already purchased interests in IHI. IHI established an
5 incentive for recruitment of downline sales representatives by
6 promising payment of override commissions to independent sales
7 representatives for IHI product and business center sales by that
8 representative's downline (retail sales organization).

9 9. According to the IHI's bi-lateral compensation plan,
10 independent sales representatives could earn override commissions
11 only if their own retail business center was "certified."

12 10. At all times material hereto, IHI promotional and sales
13 materials indicated that investors could earn up to \$2,200 to
14 \$2,500 per retail business center weekly. These projected earnings
15 were based on the recruitment of downline independent sales
16 representatives, rather than the sale of products on the retail
17 market. Similarly, the compensation structure, which included a
18 compensation cap attached to single business center earnings,
19 encouraged the purchase of multiple business centers by investors.

20 11. Although commissions on the sale of products were
21 described in the promotional and sales material, the income from
22 the development of the retail sales organization was emphasized as
23 the significant source of income from involvement with IHI.
24 Similarly, IHI disproportionately emphasized retail sales
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1 organization development through the promise of bonuses and
2 commissions which were not available to an independent sales
3 representative whose organization focused on retail product sales.

4 12. At all times material hereto, the IHI compensation
5 structure and sales pitch regarding "leveraging retail sales
6 business volume" served as incentive to develop the downline and
7 disincentive to generate retail sales business volume through the
8 sale of IHI products, thus perpetuating the pyramid scheme. The
9 IHI sales kit contains a book co-authored by Van Etten which
10 emphasizes the importance of downline regeneration. In addition to
11 emphasizing the importance of geometric growth in marketing the IHI
12 interests, IHI's training materials clearly discourage independent
13 sales representatives from developing the retail sale portion of
14 the representatives' businesses. Van Etten's book states:

15 There are two things that the successful network marketer must
16 be very good at doing which are altogether foreign to the
17 traditional salesperson: (1) He must be an organization
18 builder, and (2) He must be a teacher. We will speak of these
19 two things at much greater length later in this chapter, but
20 suffice it to say at this point that there is nothing in the
21 experience of the traditional salesperson that would cause him
22 to assign any value to either of these two skills which are so
23 essential to the individual who wants to succeed in network
24 marketing. In fact, the traditional salesperson's natural
25 tendency would be to see both organization-building and
teaching as irrelevant obstacles to be swept out of the way of
what he sees as the one all-important task of every
salesperson - selling.

Earlier in this chapter we said that there is a risk in
sponsoring persons who have considerable experience in direct
sales. This is a good place to explain why that is the case.
An experienced salesperson might come into your downline and
recruit like crazy. But if he fails to teach his recruits

1 the importance of the company's multilevel sales structure and
2 the necessity for "keeping it going," then he would **fill** your
3 downline organization with dead-end roadblocks. (Emphasis in
original).

4 13. Though references to minimum retail sales requirements
5 and inventory loading prohibitions are included in the independent
6 retail sales representative manual, IHI's compensation program is
7 based on orders of products, rather than actual sales of products,
8 and override commissions are promised for orders made within the
9 retail sales organization. Furthermore, IHI's program structure
10 does not provide a method by which inventory loading requirements
11 and requirements for retail sales to non-participants are
12 meaningfully enforced. As of the date of this order, a
13 disproportionate amount of products ordered from IHI through the
14 use of the "retail business agreement" in Montana have never been
15 received by the purchasers of the product.

16 14. On or about March 28, 1996, IHI issued a memorandum
17 addressed to all IHI representatives which required that
18 representatives wishing to conduct due diligence on the company
19 should direct "all of [their] compliance, regulatory and legal
20 questions to the Compliance Department at the home office rather
21 than the Better Business Bureau or state regulators." IHI further
22 stated that "[i]f enough inquiries are made to any one particular
23 regulatory branch, within a particular state, the result could be
24 an investigation of the Company spurred {sic} by the mere volume of
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1 calls." The memorandum further stated that:

2 The reason IHI is one of the only multilevel marketing
3 companies with a Compliance Department is so representatives
4 will have a source for receiving answers to compliance,
5 regulatory and legal questions and to assure that the Company
operates in compliance with the myriad of regulations
affecting a direct marketing sales company with operations in
48 states and 3 Canadian provinces.

6 Though the memorandum was written in March, 1996, it was included
7 in an IHI business retail business career kit sold to a Montana
8 resident months later.

9 15. Despite IHI's claims in sales presentations and materials
10 that its program complies with state and federal laws that affect
11 direct marketing organizations, IHI entered into agreements
12 limiting IHI activities in the state of North Carolina on June 3,
13 1997, and in the state of Georgia on February 10, 1998, as a result
14 of regulatory concerns in those states. North Carolina regulators
15 alleged that IHI violated North Carolina pyramid laws. These
16 actions were not disclosed to Montana residents offered or sold IHI
17 business center interests.

18 16. Between August 5, 1997, and October 31, 1997, IHI,
19 through Van Etten, Savage, Smith, and others, raised \$5 million by
20 selling IHI notes convertible into IHI common stock, to
21 approximately 95 persons in fourteen states, including at least 6
22 persons in Montana.

23 17. On August 14, 1997, IHI filed a notice filing for an
24 exemption on Form D, indicating it sold an aggregate of \$295,00 of
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1 IHI units to six accredited Montana investors. The application
2 indicated that WIN Capital was the broker/dealer making offers
3 and/or sales to Montana investors.

4 18. In connection with the offer and sale of IHI notes, IHI
5 authorized the use of a "term sheet," dated July 17, 1997, which
6 disclosed that IHI had losses of approximately \$1.9 million during
7 the first four months of 1997. The term sheet did not disclose
8 that by the time of the offering IHI's losses for the year had
9 increased to \$7.6 million, and that IHI had a shortage of operating
10 funds.

11 19. The term sheet states that IHI pays commissions and
12 bonuses "derived solely from sales as opposed to headhunting or any
13 similar activities," despite IHI's emphasis on compensation
14 opportunities based on recruitment and development of retail sales
15 organizations.

16 20. The term sheet states that representatives "who sponsor
17 other representatives must fulfill supervisory activities,
18 including ongoing communication and managerial supervision with the
19 IRSRs within their Retail Sales Organization in order to qualify
20 for ongoing commissions and bonuses," despite the absence of
21 enforcement efforts by IHI to ensure compliance.

22 21. The term sheet represents that IHI has a "a prohibition
23 from presenting hypothetical earnings projections" in sales
24 presentations, despite IHI's standard use of projections that each
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1 business center could earn up to \$2,500 weekly.

2 22. Daniels, an IHI representative in Malta, Montana, offered
3 Malta, Montana, residents the opportunity to purchase IHI notes in
4 June, 1997.

5 23. IHI represented to the Montana Securities Department that
6 the offering of IHI notes would be conducted by WIN Capital Corp.,
7 a registered broker-dealer. Daniels is not now, nor has he ever
8 been registered as a salesperson with WIN Capital Corp.

9 24. The records of the Montana Securities Department disclose
10 that Respondents were not registered as broker-dealers or salesmen
11 in this state prior to the date of this Order.

12 25. The records of the Montana Securities Department disclose
13 that the IHI business center program offered by Respondents was not
14 registered as a security in this state prior to the date of this
15 Order.

16 26. In connection with the above offers of IHI business
17 center interests to persons in Montana, Respondents failed to
18 disclose the following material facts which facts were necessary to
19 disclose in order to make the statements made about the investment,
20 in light of the circumstances under which they were made, not
21 misleading:

22 a. the market for IHI business center interests will
23 eventually become saturated as the supply of new members declines
24 and representatives recruited near the bottom of the retail sales
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1 organization structure may be unable to generate promised returns;

2 b. IHI was the subject of regulatory actions or inquiries in
3 at least three other states based on the allegation that IHI's
4 program violated state pyramid and securities laws;

5 c. that Savage and Smith were previously involved in a
6 pyramid scheme which was the subject of state and federal
7 administrative and criminal proceedings, including the issuance of
8 a permanent cease and desist order in Montana;

9 d. that IHI was not an authorized dealer for some of the
10 products listed in its retail sales catalogs and brochures; and,

11 d. at all times material hereto, IHI's program was not
12 registered as a security in the state of Montana.

13 27. In connection with the above offers and sales of IHI
14 notes convertible to IHI common stock to persons in Montana,
15 Respondents failed to disclose the following material facts which
16 facts were necessary to disclose in order to make the statements
17 made about the investment, in light of the circumstances under
18 which they were made, not misleading:

19 a. that IHI's losses for the year of 1997 had increased to
20 \$7.6 million from the \$1.9 million listed in IHI offering circular;

21 b. that IHI's compensation scheme is premised primarily on
22 recruitment of new members;

23 c. that IHI did not adequately monitor or enforce compliance
24 with IHI policies and procedures by independent sales
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1 representatives; and,

2 d. that IHI markets the business center program utilizing
3 and emphasizing hypothetical earnings projections.

4 28. In connection with the above offers of securities to
5 persons in Montana, Respondents engaged in an act, practice, or
6 course of business which operates or would operate as a fraud or
7 deceit upon any person in that:

8 a. the IHI business center program constituted a pyramid
9 scheme; and,

10 b. IHI directed sales representatives not to contact state
11 regulators in order to avoid investigations or inquiries into the
12 IHI business center program.

13 CONCLUSIONS OF LAW

14 1. The commissioner has jurisdiction over this matter by
15 reason of Respondents' offer and sale of securities to persons in
16 or from Montana.

17 2. Respondents' program is a security within the meaning of
18 the Securities Act of Montana, § 30-10-103(22), MCA.

19 3. Offer or offer to sell includes "every attempt or offer
20 to dispose of or solicitation of an offer to buy a security or
21 interest in a security for value." Section 30-10-103(15), MCA.

22 4. In connection with the above offers of securities to
23 persons in Montana, Respondents violated § 30-10-201(1), MCA, by
24 transacting business as broker-dealers or salesmen in Montana
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1 without registering as such.

2 5. In connection with the above offers of securities to
3 persons in Montana, Respondents violated § 30-10-202, MCA, by
4 transacting business in unregistered securities.

5 6. In connection with the above offers of securities to
6 persons in Montana, Respondents violated § 30-10-301(1)(b), MCA, by
7 failing to disclose the following material facts, which facts were
8 necessary to disclose in order to make the statements made about
9 the investment, in light of the circumstances under which they were
10 made, not misleading:

11 a. the market for IHI business center interests will
12 eventually become saturated as the supply of new members declines
13 and representatives recruited near the bottom of the retail sales
14 organization structure may be unable to generate promised returns;

15 b. IHI was the subject of regulatory actions or inquiries in
16 at least three other states based on the allegation that IHI's
17 program violated state pyramid and securities laws;

18 c. that Savage and Smith were previously involved in a
19 pyramid scheme which was the subject of state and federal
20 administrative and criminal proceedings;

21 d. that IHI was not an authorized dealer for some of the
22 products listed in its retail sales catalogs and brochures; and,

23 d. at all times material hereto, IHI's program was not
24 registered as a security in the state of Montana.

1 7. In connection with the above offers of securities to
2 persons in Montana, Respondents violated § 30-10-301(1)(b), MCA, by
3 failing to disclose the following material facts, which facts were
4 necessary to disclose in order to make the statements made about
5 the investment, in light of the circumstances under which they were
6 made, not misleading:

7 a. that IHI's losses for the year of 1997 had increased to
8 \$7.6 million from the \$1.9 million listed in IHI offering circular;

9 b. that IHI's compensation scheme is premised primarily on
10 recruitment of new members;

11 c. that IHI did not adequately monitor or enforce compliance
12 with IHI policies and procedures by independent sales
13 representatives; and,

14 d. that IHI markets the business center program utilizing
15 and emphasizing hypothetical earnings projections.

16 8. In connection with the above offers of securities to
17 persons in Montana, Respondents violated § 30-10-301(1)(c), MCA, by
18 engaging in an act, practice, or course of business which operates
19 or would operate as a fraud or deceit upon any person in that:

20 a. the IHI business center program constituted a pyramid
21 scheme; and,

22 b. IHI directed sales representatives not to contact state
23 regulators in order to avoid investigations or inquiries into the
24 IHI business center program.

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The above-cited violations are sufficient grounds for the imposition of an administrative fine not to exceed \$5,000.00 per violation upon any person found to have engaged in any act or practice constituting a violation of any provision of the Securities Act of Montana or any rule or order promulgated thereunder. Section 30-10-305, MCA. The above-cited violations are sufficient grounds for the imposition of and order requiring the payment of restitution and other costs to investors. Section 30-10-309, MCA. You will receive notice and/or an opportunity to be heard prior to the imposition of any fine or an order of restitution.

NOTICE

Respondents are notified that this order has been issued by the commissioner. If Respondents wish to contest the allegations herein, they shall make a written request for a hearing to Elizabeth A. O'Halloran of this office within fifteen (15) days of

1 receipt of this order. The hearing shall then be held within
2 thirty (30) days of the commissioner's receipt of the hearing
3 request unless the time is extended by agreement of the parties.
4 If no hearing is requested within fifteen (15) days of receipt of
5 this order by Respondents, and none is ordered by the commissioner,
6 this order shall become permanent.

7 Should you request a hearing, you have the right to be
8 accompanied, represented, and advised by counsel. If the counsel
9 you choose has not been admitted to practice law in the State of
10 Montana, he or she must comply with the requirements of Application
11 of American Smelting and Refining, Co., (1973), 164 Mont. 139, 520
12 P.2d 103.

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14 DATED this third day of April, 1998.

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16
17 Mark O'Keefe
18 State Auditor and
19 Commissioner of Securities
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CERTIFICATE OF SERVICE

I hereby certify that I mailed a true and correct copy of the foregoing CEASE AND DESIST ORDER to the following persons by depositing the same in the U.S. Mail - certified - return receipt requested - on this _____ day of _____, 1998.

International Heritage, Inc.
2626 Glenwood Ave., Suite 200
Raleigh, NC 27608

Stanley H. Van Etten
2626 Glenwood Ave., Suite 200
Raleigh, NC 27608

Claude W. Savage
2626 Glenwood Ave., Suite 200
Raleigh, NC 27608

Larry G. Smith
2626 Glenwood Ave., Suite 200
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Johnny Daniels
Hwy. 191
Malta, MT 59538

International Heritage Incorporated
2626 Glenwood Ave., Suite 200
Raleigh, NC 27608

State Auditor's Office